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No. 151

In the Supreme Court of the United States

OCTOBER TERM, 1941

UNITED STATES OF AMERICA, PETITIONER

v.

JOLIET & CHICAGO RAILROAD COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT
OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES

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OPINIONS BELOW

The District Court delivered no opinion. The majority and dissenting opinions in the Circuit Court of Appeals (R. 48-55) are reported at 118 F. (2d) 174.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 10, 1941 (R. 55). The petition for a writ of certiorari was filed on June 10, 1941, and was granted on October 13, 1941. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Respondent executed a perpetual lease of its railroad and equipment in consideration of an agreement by the lessee com-

pany to pay specified annual dividends to respondent's stockholders and to pay federal income taxes imposed upon respondent by reason of the dividend payments. The question is whether dividend and corresponding tax payments by the lessee constitute income to the respondent.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and regulations are set forth in the Appendix, *infra*, pp. 9-10.

STATEMENT

The facts, as stipulated (R. 30-35) and as found by the District Court (R. 36-40), may be summarized as follows:

On January 1, 1864, respondent Illinois corporation (R. 31, 36), then the owner of 37 miles of railroad between Joliet and Chicago, Illinois, and of accessory equipment, entered into a lease agreement with the Chicago and Alton Railroad Company (R. 31, 36). By the agreement (Ex. A, R. 9), respondent "demised and leased" its road and equipment to the Chicago and Alton "forever" (R. 9, 10, 31, 36). In return the lessee agreed to pay to respondent's stockholders in perpetuity an annual dividend of seven per centum on the par value of respondent's outstanding capital stock (R. 12, 13-15, 31, 36). In addition the lessee agreed to pay all taxes which might at any time thereafter be due "on account of said dividend so paid from time to time" (R. 13).

Respondent's stock issue is limited to 15,000 shares, each share having a par value of \$100 (R. 11, 12, 31-32, 36-37). The certificates of stock contain on their face a provision setting forth the obligation of the Chicago and Alton (R. 31-32, 36-37). The annual dividend is \$7 per share and totals \$105,000. This amount has been paid to respondent's stockholders every year since 1864, including the years 1931 through 1934, by the Chicago and Alton and its successor, the Alton Railroad Company (R. 32, 37). In addition, the Alton Railroad Company paid federal income taxes for respondent in the amount

of approximately \$14,000 for the year 1931 and of approximately \$16,000 for each of the years 1932 to 1934 (R. 32-33, 38, 39).¹

Respondent filed claims for refund for the income taxes paid on its behalf for the years 1931 to 1934, asserting that it had received no income in those years and that no income taxes were due from it (R. 34, 39). Upon rejection of the claims, two actions were instituted in the District Court (R. 2, 19) where they were consolidated for trial (R. 30). The District Court entered judgment in favor of the United States (R. 41). The court below reversed (R. 55), one judge dissenting (R. 53-55).

SPECIFICATION OF ERRORS TO BE URGED

The circuit court of appeals erred:

1. In holding that the dividend payments made in the years 1931 to 1934 by the lessee to respondent's stockholders and the income taxes paid with respect to those years by the lessee for the respondent did not constitute income to the respondent.
2. In reversing the judgment of the district court.

SUMMARY OF ARGUMENT

If the agreement of respondent was a lease of its property, payments by the lessee directly to the lessor's stockholders constituted rental to the lessor and therefore income taxable to it. However, the form or measure of the lessor's transfer is not significant; if the agreement be considered as a sale by respondent, the dividend payments are profits accruing to respondent in the nature of a capital gain. The Treasury regulations, in construing successive revenue acts over a long period, have required the inclusion in corporate gross income of amounts paid directly to the shareholders of corporations in respondent's present position; that long-continued administra-

¹The amount for each of the four years included additional taxes due with respect to respondent's income realized through discharge by the Alton Railroad Company of respondent's principal tax liabilities for the years in question.

tive construction, reinforced by successive reenactments of the statutory provisions, should govern this case. If the dividend payments to respondent's stockholders constituted income realized by respondent, federal income tax payments on respondent's behalf consequently were likewise income of the respondent corporation.

ARGUMENT

THE PAYMENTS IN QUESTION ARE EARNINGS OF THE RESPONDENT AND CONSTITUTE INCOME ATTRIBUTABLE TO IT IN THE YEARS IN WHICH THE PAYMENTS WERE MADE

Where a corporation leases or sells its property at a profit, it is of course taxable upon the income received as a result of the lease or sale.² If the corporation thereafter distributes such income to its stockholders, they are likewise taxable upon the dividends so received. The only question here is whether the corporate tax can be avoided when the lessee or purchaser, by arrangement, pays the rentals or purchase price directly to the corporation's stockholders.

It has long been firmly established that a corporate lessor must be treated as having received taxable income where the lessee pays the rentals to the lessor's stockholders. *Gold & Stock Telegraph Co. v. Commissioner*, 83 F. (2d) 465 (C. C. A. 2), certiorari denied, 299 U. S. 564; *United States v. Northwestern Telegraph Co.*, 83 F. (2d) 468 (C. C. A. 2) (term of 99 years); *Pacific & Atlantic Telegraph Co. v. Commissioner*, 83 F. (2d) 469 (C. C. A. 2) (term of 999 years); *American Telegraph & Cable Co. v. United States*, 61 C. Cls. 326, certiorari denied, 271 U. S. 660 (term of 50 years); *Northern R. R. of N. J. v. Lowe*, 250 Fed. 856 (C. C. A. 2); *Rensselaer & Saratoga R. R. v. Irwin*, 249 Fed. 726 (C. C. A. 2), certiorari denied, 246

² Gains from capital transactions are taxed as ordinary income in the case of corporations. *E. g.*, section 117 (c) (1), Internal Revenue Code; section 19.22 (A)-19, Regulations 103 (1940). The same result obtained under the Revenue Acts of 1928, 1932, and 1934, operative in this case. Sections 22 (a), 101, Revenue Act of 1928; sections 22 (a), 101, Revenue Act of 1932; sections 22 (a), 117, Revenue Act of 1934.

U. S. 671 (term of 500 years); *West End Street Ry. v. Malley*, 246 Fed. 625 (C. C. A. 1), certiorari denied, 246 U. S. 671 (term of 24 years); *Blalock v. Georgia Ry. & Elec. Co.*, 246 Fed 387 (C. C. A. 5); *Terre Haute Electric Co.*, 33 B. T. A. 975 (term of 999 years). Those decisions, however, do not depend on the formal circumstances of the landlord and tenant relationship; rather, they exemplify in a particular situation the general principle that a corporation is subject to income tax on the gains from its enterprise whether those gains pass actually through the corporate treasury or are distributed directly to the associated shareholders according to their respective interests.

Respondent urges here that the lease of 1864 amounted to a conveyance in fee of its property, with the result that the foregoing lease cases are not relevant.³ We think it immaterial whether the transfer to the Chicago and Alton was a true lease or constituted a sale; if a lease, the dividends paid to the stockholders of respondent amount to rent received by the corporation periodically for the use of its property over an indefinitely long term.⁴ If a sale by respondent, the dividends are installments of purchase price representing gain that accrues from the corporation's capital transaction.⁵

Respondent argues for a different result in the case of sale on the ground that the corporation no longer owns any property out of which the dividends could be said to arise as income. But that must always be true where there has been a sale of corporate assets. If the purchaser paid the sale price to the

³ In view of the length of the period of lease in many of the cases, the terms were, practically, the equivalent of perpetual leaseholds.

⁴ Not only has this Court declined to review several of the lower court lease cases, but has cited them with approval in *Old Colony Trust Co. v. Commissioner*, 279 U. S. 716, 729-730.

⁵ Respondent concedes (Br. in Opp. 3) that the dividends paid to its stockholders were income rather than a return of capital (see Pet. 5-6), and states that the only question is whose income they were.

The payments reserved by the Joliet and Chicago in its perpetual lease to the Chicago and Alton closely resemble ground rent. *Cook v. Bayonne*, 80 N. J. L. 596; *Irwin v. Bank of the United States*, 1 Pa. St. 349.

corporation in installments, the profit from the transaction would clearly be taxable to the corporation. Continuing ownership of property, then, cannot be decisive of taxability. The pivotal consideration is that by reason of its dealings with its property, whether by sale or lease, the corporation became entitled to profits which it directed to be paid⁶ to its stockholders.*

Respondent reasons here that the 1864 transaction was in the nature of a three-party novation, by which the corporation abdicated its position, leaving only the shareholders and the Chicago and Alton as parties interested in the Joliet and Chicago property. This theory is negated by the relation which the two contracting parties, respondent and the Chicago and Alton, arranged to govern all three subsequently; respondent's stockholders received the payments as dividends on stock held by them in respondent corporation; the payments were proportional to their respective stock holdings; the right to receive payments from the Chicago and Alton was inseparable from the share rights (R. 12, 16). The position of the stockholders as stockholders in respondent is greatly superior to what it would have been in the case of a reorganization in which they received stock of the Chicago and Alton in exchange for their Joliet and Chicago shares, the latter corporation being wound up, since the stockholders' right has the status of a debt owed by the Chicago and Alton.⁷ See *Rensselaer & Saratoga R. R. v. Irwin*, *supra*. Continued existence of the Joliet and Chicago Railroad as a legal entity was plainly contemplated by the parties in their provision for payment by the Chicago and Alton of salaries to specified officers of respondent (R. 16). Cf. *Gold & Stock Telegraph Co. v. Commissioner*, *supra*; *United States v. Northwestern Telegraph Co.*, *supra*.

*The argument (Br. in Opp. 7) that respondent corporation has no control over or interest in payments made by the Alton Company is untenable when it is remembered that the same is true of the lease cases in this regard.

⁷It is stipulated that the Alton Company operated at substantial net losses during all of the years 1931 through 1934 (R. 34-35).

We think that in the years after 1864 respondent's stockholders received income from the Chicago and Alton by virtue of their corporate association and, therefore, that respondent corporation realized this income. *Kansas City, St. L. & Chi. R. R. Co.*, 42 B. T. A. 1163, 1171 (perpetual lease). *Raybestos-Manhattan Co. v. United States*, 296 U. S. 60, furnishes a helpful analogy. There corporation A sold its property to corporation B in consideration of the latter's undertaking to issue an agreed number of its shares direct to A stockholders in proportion to their holdings. Liability for federal tax with respect to issue of the new stock was conceded; but the Court held that there was in addition liability for a *transfer* tax on the passage of the ownership of B stock from A to A's shareholders. Thus A incurred the same tax consequences as if it had received the stock from B and then distributed it to its stockholders. And it is settled that realization of income by a taxpayer does not require actual passage of receipts into the taxpayer's hands. Cf. *Helvering v. Horst*, 311 U. S. 112; *Helvering v. Clifford*, 309 U. S. 331; *Douglas v. Willcuts*, 296 U. S. 1; *Burnet v. Lanning*, 285 U. S. 136; *Old Colony Trust Co. v. Commissioner*, 279 U. S. 716; *United States v. Boston & Maine R. R.*, 279 U. S. 732.

Moreover, applicable Treasury regulations have long provided that dividend payments made by a lessee to the stockholders of a lessor corporation are taxable as income to the lessor, although the lessor may have conveyed away its property or ceased to engage in business. U. S. Treas. Reg. 45 (1918) Art. 546.*

If the dividend payments made by the Chicago and Alton and its successor, the Alton Railroad Company, to respondent's stockholders were income realized by respondent corporation,

* Corresponding provisions have appeared in the various additions of the regulations promulgated since that time. Art. 547, Reg. 62 (1921), 65 (1924), 69 (1926). These regulations, under the familiar rule, should be treated as controlling. Cf. *Helvering v. Winmill*, 305 U. S. 79, 82-83; *Helvering v. Wilshire Oil Co.*, 308 U. S. 90, 96.

it follows that the federal income tax payments made by the Alton Railroad Company for respondent were equally income taxable to respondent corporation. *Old Colony Trust Co. v. Commissioner, supra*; *United States v. Boston & Maine R. R., supra*.

CONCLUSION

The payments in question are earnings of the respondent and constitute income attributable to it in the years in which the payments were made. It is therefore respectfully submitted that the decision below is erroneous and should be reversed.

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NOVEMBER 1941.

APPENDIX

Revenue Act of 1928, 45 Stat. 791:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * *

Similar provisions are contained in Section 22 of the Revenue Act of 1932, 47 Stat. 169; and in Section 22 of the Revenue Act of 1934, 48 Stat. 680 (U. S. C., Title 26, Sec. 22).

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 70. *Income to lessor corporation from leased property.*—Where a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with taxes, insurance, or other fixed charges, such payments shall be considered rental payments and shall be returned by the lessor corporation as income, notwithstanding the fact that the dividends and interest are paid by the lessee directly to the shareholders and bondholders of the lessor. The fact that a corporation has

conveyed or let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax. While the payments made by the lessee directly to the bondholders or shareholders of the lessor are rentals as to both the lessee and lessor (rentals paid in one case and rentals received in the other), to the bondholders and the shareholders such amounts are interest and dividend payments received as from the lessor and as such shall be accounted for in their returns.

Similar provisions are contained in Article 70 of Treasury Regulations 77, promulgated under the Revenue Act of 1932; and in Article 22 (a)-20 of Treasury Regulations 86, promulgated under the Revenue Act of 1934.